STATEMENT OF

WASHINGTON LEGAL FOUNDATION

before the

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

of the

COMMITTEE ON FINANCIAL SERVICES OF THE U.S. HOUSE OF REPRESENTATIVES

on

"THE LONG AND SHORT OF HEDGE FUNDS: EFFECTS OF STRATEGIES FOR MANAGING MARKET RISK"

THE RELATIONSHIP BETWEEN SHORT SELLERS AND TRIAL ATTORNEYS

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Mr. Chairman and Members of the Committee:

The Washington Legal Foundation (WLF) would like to thank the committee for the invitation to submit this written statement for the record on an important issue that has not been addressed by the Securities and Exchange Commission (SEC) or, heretofore, by the Congress: the relationship between trial attorneys and short sellers.

As we will explain in greater detail, evidence suggests that trial attorneys who file class action lawsuits may be selectively providing short sellers and others with information as to when the lawsuit against a publicly traded company will be filed with the court. The stock in the company is sold short before the suit is filed, and profits are realized when the price of the stock falls after the suit is filed and made public. Other questionable devices have been used by trial attorneys, such as encouraging analysts to downgrade the stock of a targeted company to spur the company to quickly settle the underlying suit, regardless of its merits.

WLF believes that this issue has been overlooked or ignored in the post-Enron regulatory, enforcement, and legislative environment designed to restore investor confidence and integrity in the securities markets. Last week, the SEC held a Hedge Fund Roundtable over a two-day period addressing a variety of topics regarding hedge funds, short selling, and related matters; unfortunately, the issue of the relationship between short sellers and trial attorneys was not addressed, despite WLF's request to the SEC that it do so.

Accordingly, WLF applauds the efforts and interest of the committee and its staff to learn more about this aspect of abusive trading practices as part of the overall concern of hedge fund operations and regulation. WLF also encourages the committee to exercise its oversight function by making sure that the SEC addresses this matter as well.

Interests of WLF

WLF is a nonprofit, public interest law and policy center based in Washington, D.C., with supporters nationwide. Since its founding 25 years ago, WLF has advocated free-enterprise principles, responsible government, property rights, a strong national security and defense, and a balanced civil and criminal justice system, all through WLF's Litigation Department, Legal Studies Division, and Civic Communications Program.

Earlier this year, WLF launched its INVESTOR PROTECTION PROGRAM (IPP). The goals of WLF's IPP are comprehensive: to protect the stock markets from manipulation; to protect employees, consumers, pensioners, and investors from stock losses caused by abusive litigation practices; to encourage congressional and regulatory oversight of the conduct of the plaintiffs' bar with the securities industry; and to restore investor confidence in the financial markets through regulatory and judicial reform measures.

As part of WLF's IPP, we filed a complaint with the SEC on January 21, 2003 calling on the Commission to conduct to formal investigation into the short-selling of J.C. Penney Co. stock that occurred shortly before and after a major class action lawsuit was filed against Eckerd Drug Stores which is owned by J.C. Penney. As more fully described in that complaint, serious questions were raised about the selective disclosure of the timing of the lawsuit to short-sellers of J.C. Penney Co. stock as reported in a *Wall Street Journal* article of January 7, 2003, "*Suit Batters Penney Shares, But Serves Short-Sellers Well*," by David Armstrong and Ann Zimmerman. The U.S. Chamber of Commerce's Institute for Legal Reform supported WLF's complaint and urged the Commission to issue a "formal order of investigation." A copy of WLF's complaint is available on our website at *www.wlf.org*. The *Wall Street Journal* article describing the J.C. Penney lawsuit is attached hereto.

On March 24, 2003, WLF filed a Petition for Rulemaking (SEC File No. 4-477) requesting that the SEC require that prior notice be given to the public of upcoming communications between plaintiff's attorneys and analysts, hedge fund managers, short-sellers, and others in order to protect investors in companies that are being targeted for litigation from any subsequent sudden drop in the stock prices of the targeted companies. An example of this kind of contact between trial lawyers and analysts was described by reporter David Segal in his article, *Tag-Team Lawyers Make Business Blink: HMOs Latest to Grapple With Threat of Investor-Scaring Mega-Verdicts*, Wash. Post, Nov. 12, 1999 at A1, an online version of which is attached hereto. WLF's proposal is a variation of the SEC Rule FD (Fair Disclosure) which now requires company officials to make public certain discussions with analysts. WLF's rulemaking petition is also available on our website.

On April 30, 2003, WLF also filed comments with the SEC in response to request for public comments on the two-day Hedge Fund Roundtable that occurred last week. In those comments, WLF requested that the SEC's investigation of hedge funds include the issue of the relationship between plaintiffs' attorneys and short sellers. Those comments are also available on WLF's website.

In recent years, WLF has also opposed proposed class action settlements on behalf of class members objecting to excessive plaintiffs' attorneys fees, while class members receive little if any compensation. *See, e.g.*, *In re Synthroid Mkt. Litig*., 264 F.3d 712 (7th Cir. 2001); *Wilson v. Massachusetts Mutual Life Ins. Co.*, No. D0101 CV 9802814 (1st Dist., Sante Fe County, NM) (objection filed Feb. 2, 2001); *In re Compact Disc Minimum Advertised Price Antitrust Litigation*, MDL Docket No. 1361 (D. ME) (objections filed March 3, 2003). WLF has also participated in litigation opposing the filing of class action lawsuits against companies simply for failing to meet revenue and profitability projections. *See, e.g., Cypress Semiconductor Corp. v. Yourman*, 2001 Cal. App. Unpub. LEXIS 1963.

WLF's Legal Studies Division has produced and distributed timely publications on securities regulations. WLF's recently published Legal Backgrounders on the topic include: Peter L. Welsh, *Sarbanes-Oxley And The Cost Of Criminalization*; Robert A. McTamaney, *The Sarbanes-Oxley Act Of 2002: Will It Prevent Future "Enrons?*"; and Claudius O. Sokenu, *SEC Expands Foreign Corruption Law Beyond Congressional Intent*.

Finally, as part of WLF's Civic Communications Program, WLF educates the public by publishing op-eds and similar policy advertisements in the *New York Times, National Journal*, and other major publications. Three recent copies of those publications relating to trial lawyers and Wall Street are attached hereto for the record.

Accordingly, WLF has an long-standing interest in ensuring that lawsuits in general, and class actions in particular, are not prepared, discussed, and filed in such a way so as to cause needless harm to shareholders of the targeted company, or to enrich short-sellers who may have improperly received pre-filing information about the lawsuits.

Short Selling, Trial Attorneys, and SEC Regulation: A Case Example

We recognize that short selling is not inherently antithetical to the interests of investors and the securities markets. Indeed, short selling plays a positive role in the securities market by providing market liquidity and pricing efficiency. But precisely because short selling has an impact on the market, there is also potential for abuse. For example, a "bear raid" occurs when short selling is designed to drive down the price of the stock by creating an imbalance on the sell-side interest. Congress was concerned about so-called "bear raids" following the 1929 stock market crash, and in enacting the Securities and Exchange Act of 1934, Congress gave the SEC the authority to stop short selling abuses.

In response, the SEC has enacted several rules, such as Rule 10a-1 that includes the so-called "uptick" rule which essentially requires that a security may be sold short at a price above the price which the immediately preceding sale was effected. In 1963, the SEC studied short selling in response to a request by Congress, and recommended improvements in short sale data collection, but apparently no action was taken. In 1976, the SEC ordered a general investigation in short selling and considered suspending the uptick rule, but withdrew its proposals due to public opposition.

In 1991, the House Committee on Government Operations issued a report on short selling, agreed that the SEC's uptick rule was valuable as a price stabilizing force, and encouraged Nasdaq to adopt similar restrictions. Moreover, and most relevant for the hearing today, the House Report also concluded that there appeared to be "a pattern of abusive and destructive rumor mongering, targeted specifically at companies in the equity securities of which some short-selling investors have established major short positions."[1] The House Report also recommended that daily and weekly short-selling data activity and interest be obtained from broker-dealers, and be made available electronically. *Id*.

On October 20, 1999, the SEC issued a "concept release" on short selling proposing to eliminate the uptick rule in certain circumstances and to make other changes in regulating short selling. However, no further action has been taken on the subject since then, and it is unclear what the Commission may do in this area in light of the recent Hedge Fund hearings and related ongoing fact-finding by the SEC.

Congress' concern in 1991 about abusive short selling practices was well founded. To be sure, the SEC has taken some enforcement action against a few hedge fund operators and others

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[1] *Short-Selling Activity in the Stock Market: Market Effects and the Need for Regulation* (Part 1) (House Report), H.R. Rep. No. 102-414 (1991).

who have engaged in fraud and illegal market manipulation; but it has failed to address the more subtle and covert relationship between trial attorneys and short sellers that involve the selective release of nonpublic material information regarding class actions or other major lawsuits by trial attorneys with short sellers or analysts.

The following case study involving a class action lawsuit against Eckerd Drug Stores and short selling of J.C. Penney Co. stock, the parent of Eckerd, illustrates what we perceive to be a problem that undermines the integrity of the securities markets and investor confidence. The January 7, 2003 *Wall Street Journal* article referred to earlier described the Eckerd Drug case as "a window into the subculture of short sellers and class-action law firms where negative reports about companies are often seized upon and circulated, to the detriment of the companies and their stocks." *Journal* at 2. In this case, the price of Penney's stock dropped approximately 32 percent from mid-November 2001 to April 2002 when an amended complaint against Eckerd Drugs was filed. Concomitantly, short-selling of the stock rose 43 percent in the 30-day period between January 15 and February 15, 2002.

The *Journal* article raises some very serious and troubling questions about the dissemination of information regarding the timing of the filing of a potentially damaging multimillion dollar class action lawsuit against a publicly traded company, and the ensuing short-selling in the stock of the targeted company. As an initial matter, it is worth noting that the original lead plaintiff, Shirley Minsky, a 77-year old widow from Fort Lauderdale, Florida, was upset to learn from the news that she was the lead plaintiff in the suit; she angrily denied ever talking with any attorney about the suit, much less authorizing the filing of the lawsuit. According to Mrs. Minsky, the attorneys "made up the whole damn story." The lawyers scrambled to find another lead plaintiff who was substituted for Mrs. Minksy. *Gerald Mann v. Eckerd Corp.*, Docket No. 02-02311CACE(18) (Cir. Ct., 17th Jud. Dist., Broward County) (motion to dismiss third amended complaint to be heard June 26, 2003).

More troubling is the sequence of events and communications that led up to the filing of the suit. According to the *Journal* article, Don Reilly, an Eckerd pharmacist, had complained since 2000 to federal and state authorities that he believed Eckerd was overcharging for its drugs. *See Journal* at 2. He was contacted by Terrence Warzecha, an analyst who works for Rocker Partners, a New York hedge fund, who asked Mr. Reilly to talk to Eric Camil, a private investigator known to work with law firms that file class-action securities litigation. While it is not clear from the article whether Mr. Reilly spoke to the investigator, there is no doubt Mr. Reilly was repeatedly contacted by a Clifford Murray, a doctor-turned-analyst with the Boca Raton office of KSH Investment Group, Inc., (KSH), a broker-dealer based in Great Neck, New York. *Id*.

According to Mr. Reilly, Dr. Murray contacted him some "30 to 40 times" to update Mr. Reilly on the timing of the filing of the class action suit against Eckerd. *Journal* at 3. According to Mr. Reilly, Dr. Murray was "communicating with the lead plaintiffs' lawyer in the Eckerd suit before it was filed." Dr. Murray's office denies that he had advance knowledge of the suit, and claims that he "didn't talk to the lead lawyer until after the suit's filing." *Id*. The SEC needs to find out the truth of this assertion.

The lead lawyer was Paul Paradis of the New York class-action law firm of Abbey Gardy, LLP. According to the *Journal*, Mr. Paradis "didn't reply to questions about what prompted his interest in the Eckerd case or whether he discussed a possible lawsuit with short-sellers or other investment pros before filing it." *Journal* at 3. The SEC needs to ask Mr. Paradis these same questions.

The lawsuit was date-stamped at 3:59 p.m. on Friday, February 1, 2002, which is just one minute before the close of the market for the week. Jeff Sultan, the head of the local KSH, told the *Journal* reporter that his aide waited "a good part of the day" at the courthouse to get a copy of the suit, suggesting that he had pre-filing information that the suit would be filed that day. But he later said he was mistaken, claiming that he sent a messenger to get the filing on the following Monday morning. Mr. Sultan claims that neither Dr. Murray nor KSH sold Penney's stock short. But when "[a]sked why, in that case, Dr. Murray spent so much time talking to the pharmacist [Mr. Reilly], and whether the broker-dealer had been advising clients to short the stock, Mr. Sultan didn't respond." *Id*. The SEC needs to find out the answer to that question.

The *Journal* article also quoted David Rocker as stating that his fund opened "its sole short position in Penney shares on the day the suit was filed, adding to it in the following weeks." When asked by the *Journal* reporter if he had advanced knowledge that the suit was going to be filed or if he opened the short position prior to 3:59 p.m. when the suit was actually filed, Mr. Rocker was reported as saying, "I honestly don't know." The SEC needs to get an answer to that question.

In March 2002, a month after the original lawsuit was filed, the *Journal* further reported that Dr. Murray called the Eckerd pharmacist "to say he needed the documents [regarding possible overcharging] quickly." Those Eckerd documents subsequently showed up as exhibits to the first amended complaint filed in April 2002. If this is true, it suggests that Dr. Murray was indeed in contact with the plaintiffs' lawyers in the case.

By the time the amended suit was filed in April 2002, J.C. Penney stock dropped further, totaling 32 percent since mid-November 2001. In addition, short-selling activity in the stock rose 43 percent between January 15 and February 15, 2002. A subsequent investigation by the Florida Attorney General's office concluded that Eckerd did not overcharge for its drugs.

Based on this report, WLF filed a complaint with the SEC on January 21, 2003, requesting that the SEC investigate the matter and to bring appropriate enforcement action. If no SEC violations occurred, WLF also asked the SEC to inform us and the public of this result, in order to determine whether additional SEC regulations may need to be promulgated or additional legislation enacted to prevent such activity. The SEC acknowledged the receipt of our complaint by sending us a form letter that indicated that unless a public enforcement action were filed, we may never know what the SEC has done with our complaint. For all we know, the SEC may have closed the file in the case or is just letting it sit there without any active investigation. We did forward a copy our complaint to the Department of Justice which has recently informed us that it has turned the material over to the Federal Bureau of Investigation as part of the Corporate

Fraud Task Force.

The important question that we have raised by the filing of our complaint is whether the selective disclosure of the timing of the filing of a lawsuit violates any SEC law or regulation. Some have suggested that since there were no falsehoods or misrepresentations about the timing of the lawsuit, there was no fraud or improper market manipulation. We want to emphasize that we do not know whether any of the conduct described in the *Journal* article violated any SEC law or regulation. However, we would think that at a minimum, factual information, including trading, telephone, and computer records, should be obtained and examined. For all we know, an investigation may reveal that short sellers or their agents provide class action attorneys with potential damaging information about a company with the understanding that if the attorneys decide to use that information as a basis for a lawsuit, the short sellers will get a "heads up" as to when the suit will be filed.

One SEC regulation that should be relevant to any inquiry into this kind of relationship between plaintiff's attorneys and short sellers is Rule 10b-5 (17 C.F.R. § 240.10b-5). Rule 10b-5 generally prohibits traditional or classical "insider" trading as well as "misappropriation" of material information that is confidential and nonpublic. *See generally United States v. O'Hagan*, 521 U.S. 642 (1997). SEC Rules 10b5-1 and 10b5-2, promulgated in 2000 also may be relevant.

As one court described it, the "[m]isappropriation theory is targeted at `outsider' trading, i.e., breaches that do not involve a duty to the traded company and its shareholders." *United States v. Kim*, 184 F. Supp. 2d 1006, 1012 (N.D. Cal. 2002). Thus, in a classical insider trading case, an insider with material nonpublic information about the company has either traded on the information, or has tipped a friend or outsider with the information who has traded on the information. However, if someone not affiliated with the company nevertheless possesses material nonpublic information about the company, breaches a duty of trust or confidence, and trades on that information or allows others to do so, a case could be made under *O'Hagan* for insider trading.[2]

There can be no doubt, however, that attorneys have a fiduciary relationship with their clients, including those in a class action case. The attorney is an agent of his or her client who is the principal. There can also be no doubt that the filing of a multimillion dollar class action lawsuit adversely affects the price of the stock of the targeted company. Consequently, the timing of the filing of such a suit is material nonpublic information that is confidential between the lawyer and the client. Until the suit is filed, the client is free to discharge his or her attorney, or to decide not to file the suit at the last minute. The bottom line is that an attorney is not permitted to divulge filing information with short sellers without the express permission of the client.

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[2] For an excellent discussion of the judicial development of the *O'Hagan* "misappropriation" theory by the Supreme Court and lower courts, see A.C. Pritchard, United States v. O'Hagan: *Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U.L.Rev. 13 (1998).

Selectively sharing pre-filing information about the suit, and the timing of its filing, can be extremely valuable to those who engage in short-selling. As reported, allegations of overcharging had been circulated by Mr. Reilly for quite some time before the suit was filed without any significant damage to the value of J.C. Penney's stock. But the actual filing of the suit, an act almost totally within the control of the plaintiff's attorney, is itself the "bad news" that affects the price of the stock, over and above the merits of the underlying allegations. Attorneys who have practiced in this area have told us that the J.C. Penney case is not an isolated case. But only the SEC can determine the full extent of the practice, and only the SEC can take the necessary steps to prevent this kind of short-selling from taking place. The committee should demand that the SEC do so or explain to the committee why it will not undertake the necessary measures to curb this kind of short selling activity.

In addition to this kind of relationship between trial lawyers and short sellers, we would also like to bring to the committee's attention yet another tactic that has the effect of downgrading the value of a company's stock. For example, in late September 1999, the share value of national Health Maintenance Organizations (HMOs) lost over $12 *billion* in stock value in a single day following news of class action lawsuits by a consortium of plaintiffs' lawyers against the companies. *See* David Segal, *Tag-Team Lawyers Make Business Blink: HMOs Latest to Grapple With Threat of Investor-Scaring Mega-Verdicts*, Wash. Post, Nov. 12, 1999 at A1. According to the Segal article, "By leveraging the might of the stock market, these legal collectives [of plaintiffs' lawyers] are altering the balance of power in the never-ending battles between trial lawyers and the companies they sue." *Id*. at 1.

Professor George Priest of Yale Law School summarized the power that the filing of these suits have on a company's share price when he stated, "It's the fear of the nuclear-bomb verdict that gives leverage to plaintiffs' lawyers to make threats and play off a company's stock price. . . . Jury verdicts nowadays can put companies out of business." *Id*. The Segal article also noted another method used by trial lawyers to use Wall Street to depress the price of the stock of a targeted company.

> In the HMO suits, Wall Street is playing its most prominent role to date. One lawyer. . . Richard Scruggs of Mississippi, has taken the unusual step of meeting with key HMO analysts at Morgan Stanley Dean Witter and Prudential Securities and even participated in a conference call with dozens of institutional investors.

Id. at 2. According to the article, Scruggs was quoted as saying, "If HMO investors are smart, they'll lean on their companies to see if we can work something out [to settle the class action lawsuits]. *Id*. at 4. Some industry targets view these tactics to force settlements with alarm. According to Aetna's chief executive Richard L. Huber, "In one day, more than $10 billion in American savings was vaporized just by the bark of the wolf. The brazenness is astounding." *Id*. at 2.

Clearly these discussions with analysts and institutional investors can have, and do have, a significant impact on the price of the stock of the targeted company or industry. Just as clearly, it would be in the public interest for the entire investment community, including the targeted company, to be notified ahead of time of these communications and be afforded an opportunity to participate in these heretofore one-sided and biased communications. Consequently, as noted, WLF filed a Petition for Rulemaking with the SEC on March 24, 2003, to devise a disclosure rule that would require trial attorneys to give pre-notification to the SEC and the public of discussions with analysts, short sellers, and others about potential or pending lawsuits. The petition is pending before the SEC.

Conclusion

WLF appreciates the opportunity to present its views on this important topic to the committee. We look forward to working with the committee and its staff, as well as with the SEC and other regulatory and enforcement entities or agencies, to restore investor confidence and integrity in the securities markets by curbing abusive trading practices fostered by trial lawyers.

Thank you.

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